

CHINA MATTERS

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The "Equity Swap" – China's New Landscape for Mergers and Acquisitions and Overseas IPOs

Introduction

On August 8, 2006, the Ministry of Commerce (MofCom), together with the State Administration of Foreign Exchange (SAFE), the State Administration for Taxation, the State Administration of Industry & Commerce, the China Securities & Regulatory Commission (CSRC) and the State Owned Assets Supervision and Administration Commission (SASAC), promulgated the much awaited *Measures on Acquisitions of Domestic Enterprises by Foreign Investors* (New Rules), to replace the *Provisional Measures on Acquisitions of Domestic Enterprises by Foreign Investors* (Old Rules) that have been in effect since April 2003. The New Rules will become effective on September 8, 2006.

The New Rules expand the original 26 sections to 61 sections, and further organize the 61 sections into six articles. The New Rules strengthen MofCom's supervisory role, in part by requiring its approval in:

- restructures of Chinese businesses offshore; and
- acquisitions where the acquirer would:
 - control an enterprise in an "important industry";
 - control an enterprise that owns "famous trademarks" or "well-known Chinese trade names"; or
 - gain the ability to affect "China's economic security"

However, the New Rules also provide for "equity swap" and thus allow for the following cashless transactions:

- corporate restructures for initial public offerings in foreign exchanges; and
- acquisitions by foreign listed companies using their own shares.

Corporate Restructure

Under the New Rules, when a foreign company established or controlled by a Chinese company or individual wishes to acquire an affiliated Chinese company (i.e., when a Chinese company restructures its ownership offshore), MofCom's approval (at the national rather than local level) is required. To prevent the use of certain ownership or transaction structures to bypass this approval requirement, the New Rules in part rely on the use of the concept of "actual control person" of both the foreign acquirer and the Chinese company, and explicitly ban the use of trusts, nominee shareholders or other similar arrangements in such context. An "actual control person" is required to confirm to MofCom that the appraised value of the Chinese company (which forms the basis for the purchase price in such restructure) conforms with the fair market value of the Chinese company.

In the context of this general approval requirement, if a Chinese company plans to have an initial public offering (IPO) on a foreign exchange within one year, it or its shareholders may apply to MofCom to create a foreign special purpose vehicle (SPV) and "swap" shares of the SPV for equity in the Chinese company. As a part of the application, the Chinese company is required to submit the SPV's IPO plan and an IPO offer price estimate report from a mergers and acquisitions advisor that is licensed in China (M&A Advisor) to MofCom. The appraised value of the Chinese company may not be higher than the corresponding portion of the SPV's market capitalization at the IPO.

After MofCom's approval of an equity swap, the applicant is required to obtain CSRC's approval to list outside China, but only in jurisdictions where the securi-

ties regulatory authorities have entered into memoranda of understanding, and have maintained effective cooperative working relationships, with CSRC (e.g., the United States and Hong Kong). After the IPO, the SPV is required to repatriate the IPO proceeds back into China. If the IPO does not occur within one year after the issuance of the provisional new business license, MofCom's approval expires and the swap is automatically reversed.

Acquisition by a Foreign Listed Company

Under the New Rules, an acquirer may use its own shares (as opposed to using only cash) as acquisition currency, provided that:

- the acquirer is duly organized in a jurisdiction that has well-developed corporate laws;
- the acquirer and its management personnel have not been subject to any penalty from governmental authorities during the past three years;
- the shares to be used as acquisition consideration are:
 - legally issued or held;
 - freely transferable and not subject to any lien, encumbrance or pledge;
 - listed on a legally established securities exchange outside China (excluding over-the-counter markets); and
 - traded at stable prices during the past year;
- the M&A Advisor performs diligence, and delivers a report, on the corporate records and financial conditions of the acquirer, and confirms that the requirements with respect to the acquirer and its shares set forth above are satisfied; and
- the acquisition is completed within six months after the issuance of the provisional business license.

If an acquirer, through an acquisition in China, would control an enterprise in an important industry or an enterprise that owns "famous trademarks" or "well-known Chinese trade names," or would gain the ability to affect China's economic security, the acquirer is required to disclose such possibility to MofCom. A failure to make such disclosure would give MofCom the authority to demand a transfer of equity interest or assets, or other measures to eliminate such effect on China's economic security caused by the acquisition.

Related Rules and Regulations

The New Rules reaffirm coordination with other regu-

latory frameworks in China's M&A and IPO regimes – various industries remain restricted from foreign ownership; foreign strategic investors may acquire A-shares of Chinese listed companies upon CSRC's approval; registration with SAFE may be necessary; and all applicable taxes must be paid.

As under the Old Rules, foreign investments in and acquisitions of foreign invested enterprises remain outside the scope of the New Rules. In addition, other specific rules and regulations may apply when a foreign acquirer acquires a foreign invested enterprise, when a foreign invested enterprise acquires another foreign invested enterprise, when a limited liability company converts into a company limited by shares upon acquisition by a foreign acquirer, and when the target is publicly traded outside China. In all such instances, the New Rules would apply if the more specific rules or regulations are silent on certain issues.

Market Implications

The New Rules create a centralization of foreign investment approval powers under specific circumstances, and reflect an integration of the Chinese Government's experience regulating foreign investments over the past decade. For example, although CSRC has stopped issuing "no objection" letters with respect to red chip listings since 2003, and SAFE aborted its attempt in 2005 to regulate red chip listings through Circulars Nos. 11 and 29, it now appears the New Rules will give MofCom a greater role in regulating the flow of private equity investments into offshore holding companies of Chinese businesses, as well as their listings on foreign exchanges.

Despite the explicit "paths" provided for foreign listings and acquisitions in the New Rules, many uncertainties remain as to the likelihood of obtaining MofCom's approval. For example, if MofCom and CSRC wish to encourage Chinese companies to list locally on the A-share market (especially after the completion of the A-share reform), foreign investors and Chinese companies may find it more difficult to obtain MofCom's approval.

The lack of guidance (at least initially) on the meanings of words like "important industry," "China's economic security," "stable prices" of listed shares, and so forth, will also likely slow down transactions as investors and Chinese companies alike try to determine if they fall within certain definitions.

On the one hand, "pre-IPO" private equity financing that are principally related to restructuring Chinese compa-

nies offshore will likely decrease because IPO candidates now have an explicit “path” to an overseas listing. On the other hand, multinational corporations may find the ability to acquire Chinese companies with listed shares attractive, and mergers and acquisitions activities may increase.

The New Rules, together with the A-share reform and the regulations adopted in January 2006 relating to investments by foreign strategic investors in China’s listed companies, as well as the tender offer rules promulgated by CSRC in July 2006, are rapidly transforming China’s landscape for private equity investments, mergers and acquisitions and public offerings.

Please feel free to contact any of our lawyers listed below if you have a proposed transaction that may be affected by the New Rules, or have questions regarding the New Rules.

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